

REPORT OF EXAMINATION
OF THE
AMERICAN CONTRACTORS INDEMNITY COMPANY

AS OF
DECEMBER 31, 2002

Participating State
and Zone:

California

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Los Angeles, California
October 10, 2003

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable John Morrison
Secretary, Zone IV-Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

AMERICAN CONTRACTORS INDEMNITY COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 9841
Airport Boulevard, 9th Floor, Los Angeles, California 90045.

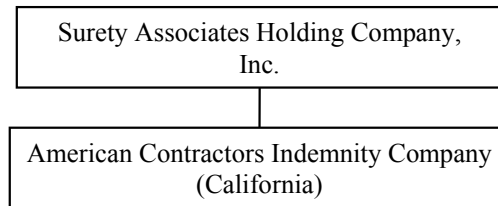
SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1999. This examination covers the period from January 1, 2000 through December 31, 2002. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2002, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history, fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Surety Associates Holding Company, Inc., a New Mexico insurance holding corporation, is the ultimate controlling entity. The following organizational chart depicts the Company's relationship within the holding company system:



Management of the Company is vested in a six-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2002 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Corby Baumgarten Los Angeles, California	Chairman of the Board Surety Associates Holding Company Inc.
Robert F. Thomas Pacific Palisades, California	Chief Executive Officer American Contractors Indemnity Company
Andy T. Faust, Jr. (*) Marina Del Rey, California	President American Contractors Indemnity Company
William LeVine Beverly Hills, California	Chairman of the Board American Contractors Indemnity Company LeVine Investments
Erwin B. Pearl Palm Springs, California	Retired Pharmacist
Ron Berger Portland, Oregon	Chairman and Chief Executive Officer Figaro's Italian Pizza, Inc.

(*) retired effective February 2003, replaced by Leon Back

Principal Officers

<u>Name</u>	<u>Title</u>
Robert F. Thomas	Chief Executive Officer
Andy T. Faust, Jr. (*)	President
Leon B. Back, Jr.	Senior Vice President
James H. Ferguson	Vice President, Secretary, Treasurer and Chief Financial Officer
Scott D. Anschultz	Vice President
Cyndi J. Beilman	Vice President
George S. Hadley	Vice President
Regan D. James	Vice President
Frank M. Lanak	Vice President
Deborah A. Reese	Vice President

Name

Title

Norma Virgilio

Vice President

(*) retired effective February 2003, replaced by Robert F. Thomas

Management Agreement

Tax Sharing Agreement: The Company is part of a consolidated federal income tax agreement with its ultimate parent, Surety Associates Holding Company, Inc. All taxable income and deductions of the parent are allocated to the Company and included in the calculation of income taxes.

CORPORATE RECORDS

During the examination period and during 2003, the Company paid the following dividends to its parent, Surety Associates Holding Company Inc.:

<u>Date</u>	<u>Amount</u>	<u>Type</u>	<u>Description</u>
January 11, 2001	\$ 353,775	Ordinary	Cash
January 10, 2002	2,301,128	Ordinary	Cash
January 24, 2003	79,236	Ordinary	Cash
March 17, 2003	101,371	Ordinary	Cash
June 13, 2003	<u>105,146</u>	Ordinary	Cash
Total	<u>\$2,940,656</u>		

All stockholders dividends were reported to the California Department of Insurance.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2002, the Company was licensed to transact surety business. The following is a listing of the states in which the Company is licensed:

Alabama	Hawaii	Maryland	New Mexico	South Dakota
Arizona	Idaho	Minnesota	North Dakota	Tennessee
Arkansas	Indiana	Mississippi	Ohio	Texas
California	Iowa	Missouri	Oklahoma	Utah
Colorado	Kansas	Montana	Oregon	Virginia
Delaware	Kentucky	Nebraska	Pennsylvania	Washington
Florida	Louisiana	Nevada	Rhode Island	West Virginia
Georgia	Maine	New Jersey	South Carolina	Wyoming

The Company is also licensed in the District of Columbia, Commonwealth of the Northern Mariana Islands, and Guam. An application for a certificate of authority is pending in the State of North Carolina. The Company plans to file for admission in all remaining states and territories. The primary mix of business consists of court bonds, license and permit bonds, contract bonds, customs bonds, bail bonds and miscellaneous. Business is produced through 3400 independent agents and brokers. The Company has 19 branch offices.

In 2002, the Company wrote \$44.7 million of direct premiums. Of the direct premiums written, 81% or \$36 million was written in California, \$1.7 million (4%) was written in Texas, \$1 million (2%) was written in Florida and \$6 million (13%) was written in the remaining states.

REINSURANCE

Assumed

The Company entered into an assumption reinsurance agreement with Lyndon Property Insurance Company as part of a fronting arrangement, whereby the Company assumed 100% of the business because its rates had not been approved in the State of Washington. The agreement with Lyndon

Property Insurance Company was effective March 1, 2002 to March 1, 2003. The amount of premiums attributable to this agreement in 2002 was \$105,681.

Ceded

Effective December 31, 2001, the Company entered into a quota share reinsurance treaty with three reinsurers; Everest Reinsurance Company (42.5%), XL Reinsurance America, Inc. (42.5%) and Continental Casualty Company (15%). Limits under the contract are as follows:

Bond Size	Company's Retention	Percentage Ceded
\$ 0 to \$ 250,000	87.5%	12.5% not to exceed \$31,250
\$ 250,000 to \$1,000,000	75.0%	25.0% not to exceed \$250,000
\$1,000,001 to \$1,500,000	50%	50.0% not to exceed \$750,000
\$1,500,001 to \$3,000,000	25.0%	75.0% not to exceed \$2,250,000
\$3,000,001 and greater	Special acceptance	Special acceptance

This contract applies to court and contract bonds. The Company's maximum net exposure under this treaty is \$750,000.

For contract surety bonds that are subject to the Small Business Administration (SBA) Surety Bond Guarantee Program, limits under the contract are as follows:

Bond Size	Company's Retention	Percentage Ceded
\$ 0 to \$ 500,000	100.0%	0%
\$500,001 to \$1,250,000	36.0%	64.0 not to exceed \$768,000

Under this program the SBA will reimburse the Company 90% (80% for non-minority bonds over \$200,000) of its net loss in exchange for 20% of the net premium. Effective January 1, 2000, SBA bonds were no longer ceded to the Company's reinsurers. The maximum amount the Company can retain is based on the T-rating (the maximum amount of bond the Company can retain, net of reinsurance) determined by the United States Treasury Department.

A review of the Company's quota share reinsurance contract indicated that the insolvency clauses did not include the exact wording of the first sentence of California Insurance Code (CIC) Section 922.2(a)(2) as required by the California Department of Insurance. Effective August 29, 2003, the Company amended this contract to include the appropriate language as required by CIC Section 922.2(a)(2).

ACCOUNTS AND RECORDS

Losses

A review of a random sample of claims reported to the Company disclosed deficiencies in the historical loss and loss adjustment expense data contained in the claim file as compared to the information on the Company's claims system. The inconsistencies included incorrect loss and expense paid amounts, and incorrect case loss reserves. The inconsistencies were primarily a result of the claim check number being incorrectly applied to the wrong claim number in the claim check and subrogation register. It is recommended that the Company establish and implement written procedures and quality assurance/quality control tests to ensure that all information contained in the claim files agrees with the information on all of its computer systems.

Collateral Held by the Company

In order to reduce the risk associated with surety business, the Company obtains collateral from the bond principals. The market value of the collateral as stated by the Company, as of December 31, 2002, was approximately \$388.6 million. Such collateral was not carried in the Company's financial statements. Interest earned by the Company on collateral held totaled \$1.15 million in 2002.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2002

Underwriting and Investment Exhibit for the Year Ended December 31, 2002

Reconciliation of Surplus as Regards Policyholders
from December 31, 1999 through December 31, 2002

Statement of Financial Condition
as of December 31, 2002

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 31,219,164	\$	\$ 31,219,164	
Stocks:				
Preferred stocks	5,628,500		5,628,500	
Common stocks	555,571		555,571	
Mortgage loans on real estate:				
First liens	370,566		370,566	
Cash and short-term investments	4,942,811		4,942,811	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	4,180,516	1,265,097	2,915,419	
Reinsurance recoverable on loss payments	(676,404)		(676,404)	
Federal income tax recoverable	1,401,835		1,401,835	
Electronic data processing equipment	253,968		253,968	
Interest, dividends, and real estate income due and	739,932		739,932	
Other assets nonadmitted	98,317	98,317		
Aggregate write-ins for other than invested assets	<u>213,505</u>	<u>213,505</u>		
Total assets	<u>\$ 48,928,281</u>	<u>\$ 1,576,919</u>	<u>\$ 47,351,362</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 7,097,226	(1)
Loss adjustment expenses			1,156,986	(1)
Commissions payable, contingent commissions and other similar charges			542,599	
Other expenses			726,249	
Taxes, licenses and fees			465,999	
Federal and foreign income taxes			53,360	
Unearned premiums			18,493,380	
Ceded reinsurance premiums payable			<u>188,226</u>	
Total liabilities			28,724,025	
Common capital stock		\$ 2,100,000		
Gross paid-in and contributed surplus		7,562,169		
Unassigned funds (surplus)		<u>8,965,168</u>		
Surplus as regards policyholders			<u>18,627,337</u>	
Total liabilities, capital and surplus			<u>\$ 47,351,362</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2002

Statement of Income

Underwriting Income

Premiums earned		\$ 33,175,963
Deductions:		
Losses incurred	\$ 5,147,671	
Loss expense incurred	2,373,535	
Other underwriting expenses incurred	<u>24,075,124</u>	
Total underwriting deductions		<u>31,596,330</u>
Net underwriting gain		1,579,633

Investment Income

Net investment income earned	\$ 3,518,060	
Net realized capital losses	<u>(256,822)</u>	
Net investment gain		3,261,238

Other Income

Finance and service charges not included in premiums	\$ 41,347,199	
Net loss from agents' balances charged off	<u>(41,347,199)</u>	
Total other income		<u>0</u>
Net income before federal income taxes		4,840,871
Federal income taxes incurred		<u>1,801,000</u>
Net income		<u>\$ 3,039,871</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2001		\$ 16,221,176
Net income	\$ 3,039,871	
Net unrealized capital gains	38,258	
Change in net deferred income tax	2,216,312	
Change in nonadmitted assets	(587,152)	
Dividends to stockholders	<u>(2,301,128)</u>	
Change in surplus as regards policyholders		<u>2,406,161</u>
Surplus as regards policyholders, December 31, 2002		<u>\$ 18,627,337</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 1999 through December 31, 2002

Surplus as regards policyholders, December 31, 1999,
per Examination \$ 11,279,354

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$8,549,851	\$
Net unrealized capital gains	839,719	
Change in net deferred income tax	2,193,312	
Change in nonadmitted assets		914,847
Cumulative effect of changes in accounting principles		665,150
Dividends to stockholders (cash)		2,654,903
Aggregate write-ins for gains in surplus	<u>1</u>	<u> </u>
Totals	<u>\$ 11,582,883</u>	<u>\$ 4,234,900</u>

Net increase in surplus as regards policyholders 7,347,983

Surplus as regards policyholders, December 31, 2002,
per Examination \$ 18,627,337

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on a review of the Company's loss and loss adjustment expense reserves by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses as of December 31, 2002 appear reasonable and have been accepted for purposes of this examination report.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records (Page 8): It is recommended that the Company establish and implement written procedures and quality assurance/quality control tests to ensure that all information contained in the claim files agrees with the information on all of its computer systems.

Previous Report of Examination

Corporate Records (Page 4): Company did not comply with notification to board members of the receipt of the Report of Examination. The Company is now in compliance with California Insurance Code (CIC) Section 735.

Reinsurance (Page 5): Reinsurance contract did not contain exact wording of first sentence of CIC Section 922.2(a)(2). The Company's reinsurance agreement is now in compliance.

Reinsurance (Page 7): Recommendation was made that extra contractual obligations be excluded in those jurisdictions where it not allowed. The Company's reinsurance agreement is now in compliance.

Accounts and Records –Bond Numbers (Page 8): It was recommended that the Company institute procedures to account for and reconcile all bonds on a regular basis. The Company instituted procedures to account for all bonds and powers of attorneys on a regular basis.

Agents' balances or uncollected premiums (Page 13): It was recommended that the Company use bond effective date to age its agents' balances. This recommendation was implemented.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

Laura Clements
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California